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JUN 30 1938
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CLERK

No. 163

# In the Supreme Court of the United States

OCTOBER TERM, 1938

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

*v.*

WILSHIRE OIL COMPANY, INC.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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**PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT**

The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Ninth Circuit, entered in the above entitled cause on April 1, 1938, affirming a decision of the Board of Tax Appeals.

**OPINIONS BELOW**

The opinion of the Board of Tax Appeals (R. 54–56) is reported in 35 B. T. A. 450. The opinion of the Circuit Court of Appeals is reported in 95 F. (2d) 971.

## JURISDICTION

The judgment of the Circuit Court of Appeals was entered April 1, 1938. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

## QUESTION PRESENTED

Whether, in determining the amount of depletion allowable under Section 114 (b) (3) of the Revenue Act of 1928, development expenditures and the related depreciation which the taxpayer elected to deduct currently should be deducted from "the gross income from the property" in arriving at "the net income of the taxpayer" from the property for the purpose of applying the 50 per cent limitation provided therein.

## STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (1) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be

prescribed by the Commissioner, with the approval of the Secretary. * * *

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Treasury Regulations 74, promulgated under the Revenue Act of 1928:

ART. 221. *Depletion of mines, oil and gas wells; depreciation of improvements.*—

* * *

* * * * *

(i) "Depletion allowance based on the income from oil and gas wells": The deduction for depletion based on the income from oil and gas wells shall not exceed 50 per cent of the net income of the taxpayer, computed without allowance for depletion, from the property, except that in no case shall the

depletion allowance be less than it would be if computed without reference to the income from the property. The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, development expenses (if the taxpayer has elected to deduct development expenses), depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. * * *

* * * * *

ART. 243. *Charges to capital and to expense in the case of oil and gas wells.*—Such incidental expenses as are paid for wages, fuel, repairs, hauling, etc., in connection with the exploration of the property, drilling of wells, building of pipe lines, and development of the property may at the option of the taxpayer be deducted as a development expense or charged to capital account returnable through depletion. If in exercising this option the taxpayer charges these incidental expenses to capital account, in so far as such expense is represented by physical property it may be taken into account in determining a reasonable allowance for depreciation. The cost of drilling nonproductive wells may at the option of the operator be deducted from gross income as a development expense or charged to capital account returnable through depletion and depreciа-

tion as in the case of productive wells. An election once made under this option will control the taxpayer's returns for all subsequent years. * * *

## STATEMENT

The facts may be summarized as follows (R. 48–53):

The respondent is a California corporation engaged in the business of producing oil and gas from various properties located in Southern California (R. 48). In filing its income tax returns for the years 1929 and 1930, the respondent, pursuant to the regulations, claimed and was allowed as deductions from gross income so-called development expenditures in the respective amounts of $606,051.66 and $279,927.04 (R. 52–53). The respondent claimed, however, that in determining its "net income * * * from the property" for the same years, for the purpose of computing the allowable depletion under Section 114 (b) (3) of the Revenue Act of 1928, the development expenditures were not to be deducted. The Board of Tax Appeals upheld this contention of the taxpayer (R. 54–58), and the decision of the Board was affirmed by the Circuit Court of Appeals, Judge Wilbur dissenting (R. 75–84).

## SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the depletion allowance under Section 114 (b) (3) of the Revenue Act of 1928

should be computed without taking into consideration development expenditures and the related depreciation, which items were claimed by the respondent and allowed as deductions in computing the taxable net income for the years in controversy.

2. In holding that development expenditures and the related depreciation, which items the respondent elected to deduct currently, should not be deducted in computing "the net income * * * from the property" under Section 114 (b) (3) of the Revenue Act of 1928.

3. In failing to reverse the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The Circuit Court of Appeals, in holding that the allowable depletion under Section 114 (b) (3) of the Revenue Act of 1928 should be computed without deducting so-called development expense and the related depreciation, which the respondent elected to deduct currently, has decided an important question of Federal tax law which has not been but should be settled by this Court.

Section 114 (b) (3) of the Revenue Act of 1928 provides that the allowance for depletion shall be 27½ per cent of the gross income from the property but such allowance shall not exceed 50 per cent of the net income (computed without allowance for depletion) from the property. Article

243 of Regulations 74,[1] *supra*, permits taxpayers to choose whether to capitalize development expenses or to deduct them from income currently. Pursuant thereto the respondent charged to expense and deducted in its income tax returns for the years 1929 and 1930 development expenses in the respective amounts of $606,051.66 and $279,927.04 and such amounts were allowed as deductions in computing the net income upon which the tax was levied. However, under the decision of the court below, such expenditures need not be deducted in computing the net income from the property for the purpose of determining the allowable depletion.

The court below fell into error in assuming that the expenses in question were capital expenditures. It lost sight of the fact that if a taxpayer elects to deduct such expenses currently, they are then no different than any other expense items connected with the property. The effect of the decision is to permit taxpayers to call the same expenditures capital expenses for one purpose and ordinary and necessary expenses for another purpose. We sub-

[1] All the regulations of the Commissioner, beginning with those issued under the Revenue Act of 1918, have permitted an election with respect to the treatment of development expenses. However, the election, once made, was binding upon all subsequent years' returns. In view of the new basis for depletion provided in the Revenue Act of 1926, a new election, binding upon all subsequent years, was permitted. See T. D. 4025, VI-1 Cumulative Bulletin 75.

mit that, having made an election, a taxpayer should be held to that election for all purposes.

Our contention that development expense should be included in the computation in arriving at the net income from the property where taxpayers have elected to deduct such expenses currently is borne out by the very language of Section 114 (b) (3). It provides that the allowance for depletion "shall not exceed 50 per centum of the net income of the taxpayer (*computed without allowance for depletion*) from the property." [Italics supplied.] Since depletion is an allowable deduction, the specific direction that it shall be excluded from the computation in determining the net income from the property precludes the exclusion of any other deductible item. *Wood* v. *United States*, 16 Pet. 342, 363.

2. The decision of the court below unwarrantably invalidates a Treasury Regulation. Article 221 (i) of Regulations 74 reads in part as follows:

> The phrase "net income of the taxpayer (computed without allowance for depletion)" means the gross income from the sale of oil and gas less the deductions in respect to the property upon which depletion is claimed, including overhead and operating expenses, *development expenses (if the taxpayer has elected to deduct development expenses)*, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. [Italics supplied.]

This regulation is not, as the court below erroneously assumed, a mere administrative interpretation promulgated by the Commissioner under his general power to issue rules and regulations. The regulation was issued by the Commissioner under the specific authority of Section 23 (1) of the Revenue Act of 1928, *supra*, p. 2, which provides for the deduction of—

> a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; *such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner*, with the approval of the Secretary. [Italics supplied.]

The Commissioner having determined, with the approval of the Secretary, that a reasonable allowance for depletion does not include, in effect, a double deduction—or partially double deduction—on account of development expenditures, the Board and the court below were without power to set the determination aside merely on the ground that in their view of the law apart from the regulation the taxpayer's contention was correct.[2] Moreover,

[2] Article 221 (i) of Regulations 74 is the first regulation specifically dealing with the treatment of development expenditures, which the taxpayer has elected to deduct currently, in the computation of the depletion allowance. The court below relied (R. 77) on expressions in earlier regulations (e. g., Revenue Act 1921, Regulations 62, Art. 201 (h)) limiting the deductions in determining "net income from the property" to "operating expenses." It seems apparent that

even if the regulation had originally no greater force than an administrative interpretation, it should have been followed in view of the later legislative history. The regulation has been carried forward and incorporated in all the regulations issued under the subsequent Revenue Acts.[3] Likewise, the provision limiting depletion to "50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property" has been reenacted without change in the Revenue Acts of 1932, 1934, 1936, and 1938. The argument is compelling that the subsequent reenactment of the same provision in the later Revenue Acts constituted legislative approval of the Commissioner's regulations. *United States* v. *Dakota-Montana Oil Co.*, 288 U. S. 459; *Brewster* v. *Gage*, 280 U. S. 327.

3. The decision of the court below is in conflict with the principles enunciated by this Court in *United States* v. *Dakota-Montana Oil Co., supra,* where it was held that development expenses which the taxpayer had elected to capitalize should be recovered through allowances for depletion. It would seem to follow that, if such expenses, when

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development expenditures and the related depreciation are "operating expenses" within the meaning of these regulations when the taxpayer has elected to deduct them currently in computing net taxable income.

[3] See Article 221 (h) of Regulations 77; Article 23 (m)–1 (h) of Regulations 86; and Article 23 (m)–1 (h) of Regulations 94.

capitalized, are recoverable through deductions for depletion, they should not be used when expensed currently to increase the depletion allowance.

4. The Bureau of Internal Revenue advises that the issue here raised is presented in 107 cases, involving approximately $9,000,000 in taxes, now pending before the Board of Tax Appeals and the Income Tax Unit.. It further advises that the question is present in numerous other cases, but because of the manner in which the returns are prepared, the amount involved cannot readily be determined. The question arises in every case where percentage depletion is claimed and is of sufficient importance, we believe, to warrant clarification by this Court.

## CONCLUSION

Wherefore it is respectfully submitted that this petition for a writ of certiorari should be granted.

ROBERT H. JACKSON,
*Solicitor General.*

JUNE 1938.

U. S. GOVERNMENT PRINTING OFFICE: 1938